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STATE OF NEW MEXICO
THIRTEENTH JUDICIAL DISTRICT
COUNTY OF VALENCIA

SOCORRO ELECTRIC COOPERATIVE, INC.,

Plaintiff,

v.

CHARLENE WEST, et al.,

No. D1314-CV-2010-0849
Judge: Mitchell

Defendants,

And

CHARLES WAGNER, individually and on behalf of those similarly situated, et al.,
Cross Claim Plaintiff,

v.

SOCORRO ELECTRIC COOPERATIVE, INC., et al.,
Cross Claim Defendants.

MEMORANDUM BRIEF:

ADDRESING MATTERS OF COURT AUTHORTIY TO REVIEW ACTIONS OF CORPORATE BOARD OF TRUSTEES

The current Memorandum Brief is filed by Defendant Socorro Electric Cooperative, Inc, (hereinafter "Socorro" or "SEC") pursuant the Court's letter of August 14, 2012. In this letter, the Court sought briefing and legal argument addressing matters related to the Court's authority to review actions of a corporate board of directors and to potentially impose its own business judgments on a private corporation. Specifically, the Court requested that the parties provide "citations and arguments" focusing on what power, if any, the Court had to "fix" allegedly faulty

corporate governance, and what remedies would be appropriate if the Court were to ultimately grant certain of Plaintiffs' claims.

As shall be discussed in more detail below, Defendant SEC argues that the Court has a highly limited authority to review the business decisions of a corporate board. The Court has even less authority to invalidate the democratic election process whereby trustees are popularly elected by the membership of an electric cooperative. New Mexico courts are *not* empowered to substitute their business judgment for that of elected trustees, nor are our Courts empowered to install themselves as corporate overseers, directing the business affairs of lawfully established New Mexico corporations. Furthermore, even in those rare circumstances where Courts have found that a corporation's business decisions are not undertaken in good faith, and thus were not entitled to the protections of the "business judgment rule," the proper remedy is to invalidate the particular decisions under consideration, just as the Court would invalidate improper clauses or terms in an otherwise valid contract. The business entity, here SEC, is then left to reformulate its own business decisions and carry forth with is business activities without further interference from the courts. To the best understanding of Defendant's counsel, triers of fact (whether judge or jury) are not empowered to determine the proper course of action that a corporate board *should have taken*. Rather, at most, such triers of fact are asked only to determine if the actual acts undertaken should be invalidated based on a lack of good faith by the corporate directors/trustees.

However, focusing on the specific counts and requests for relief contained in the proposed "First Amended Cross Claim and Request for Class Action Certification" presented to the Court by proposed Plaintiffs Carol Auffrey and Herbert Myers, it is clear that the many of the

Court's concerns are addressed by the limited nature of the pleadings, which no longer fundamentally address matters of corporate governance.

I. Plaintiffs' Request for Declaratory Judgment.

Plaintiffs' first request for relief, as stated in the proposed "First Amended Cross-Claim" at Para. 71, focuses on declaratory relief. Even if the Court were to enter the declaratory statements "a", "b" and "c" asserted by Plaintiffs in Para. 71 of their proposed Cross-Claim, the Court would not be entering any extraordinary or unusual relief. These statements, if issued by the Court, would only serve as ordinary statements of legal principal. As for statements "d" and "e", addressing the alleged right to an "accounting" and counsel's alleged right to reasonable and necessary attorney's fees, these issues are addressed through Plaintiffs' independent claims for relief.

Additionally, Defendant's counsel would point-out that Plaintiffs' request for declaratory relief renders Plaintiff's request for class action certification moot. This Court, in this very matter, has ruled that declaratory judgments are "generally binding on all interested individuals and entities, including those which are not represented before this Court." See, *Decision Regarding Applicability of Relief*, filed March 29, 2011, at Para. 4.

Thus, while Defendant continues to assert that the requested declaratory relief should be denied as improper and lacking in legal relevance, the consideration of such relief does not raise any unusual questions of corporate governance and does not in any way justify a request for class certification.

II. Plaintiffs' Request for Injunctive Relief as to Election Districts.

Plaintiffs' second request for relief clearly raises a novel issue touching on the extent of this Court's authority to use its equitable powers to compel positive action from a private corporation. Plaintiffs ask the Court to independently revise existing election districts, and that the Court do so in the "spirit of 'one man, one vote.'"

However, the Court need not expend its valuable time addressing this request, because the Plaintiffs have dropped all claims which would touch on or concern voting districts. The only remaining claims in Plaintiffs' First Amended Cross-Claim concern alleged excessive compensation and matters concerning capital credits. None of the allegations made as to these two claims has any relevance to voting districts.

Defendant's counsel reasonably believes, based on conversations with Plaintiffs' counsel and based on the issues raised by Plaintiffs and their counsel at the July 3, 2012 special Board meeting, that requests for the reformation of voting districts are a relic of the earlier, original Cross-Claim filed against the SEC by its own Trustee: Mr. Charles Wagner. Mr. Wagner's Cross-Claim contained allegations of fraud, fraudulent concealment, and denial of voting rights. These allegations and counts are no longer contained in the proposed First Amended Cross-Claim.

Furthermore, at least since the issuance of the Court's June 2011 "Order on Hearing on Partial Merits", filed June 24, 2011, Defendant SEC, its trustees, officers and counsel, have been working to revise the voting districts and put into practice the member-enacted changes to the corporate By-laws discussed in that Order. Plaintiffs and their counsel are well aware that voting districts have been re-drawn, voting procedures have been updated, and voting is scheduled to

occur under these new procedures and for newly revised districts in the upcoming months. Thus, any lingering claims as to voting districts appear to be moot and need not concern the Court.

III. Plaintiffs' Request for Accounting and Disgorgement.

a. Accounting

At Paragraph 73 of their proposed First Amended Cross-Claim, Plaintiffs ask that the Court again exercise its equitable authority so as to order Defendant SEC to provide an "accounting" for various financial activities. Generally, an accounting is an equitable remedy used after a plaintiff has established an unjust enrichment or fraud claim.

However, in the current matter, the Plaintiffs already have access to the very financial documents they are claiming to seek. Trustee compensation and benefits are the subject of required annual financial filings, known as Securities and Exchange Commission Form 990. Defendant SEC has consistently filed these forms for each Trustee as required by law, and the completed forms are publicly available. In fact, Plaintiffs' counsel clearly used these forms to complete Paragraphs 33 – 37 of the First Amended Cross-Claim, which include detailed statements as to trustee compensation and hours.

Similarly, Defendant SEC has regularly and properly accounted for capital credits, profits, losses, revenues, etc., as required by relevant statutes and by Defendant's lenders. Plaintiffs' counsel is well aware of the accounting procedures that have been regularly followed by Defendant SEC, and counsel has acknowledged that the accounting firm used by Defendant, (Bolinger, Segars, Gilbert & Moss, LLP of Lubbock, Texas) is the preeminent financial accounting firm in the field of electrical cooperatives.

Finally, to the extent that Plaintiffs seek further or additional financial information, it is important to note that an action for accounting is by its very nature a derivative action, and not a direct action. An action for accounting cannot be maintained by shareholders in their individual capacities. See, *Schwartzman v Schwartzman Packing Company*, 99 NM 436, 441, 659 P.2d 888, 893 (1983). The importance of this legal principle to the Court's concerns regarding authority and remedy are addressed below. See, *Sec. IV*.

b. Disgorgement

As to the issue of disgorgement, at Paragraph 74 of the proposed First Amended Cross-Claim, Plaintiffs request that the Court order disgorgement of "all excessive compensation and benefits" and for "Patron's Capital" which should have been retired and reimbursed.

Generally, disgorgement is understood as an equitable remedy most commonly seen in securities fraud cases. In that context, disgorgement serves both to prevent the wrongdoer's unjust enrichment and to deter others' violations of the securities laws. *See, United States v. Nacchio*, 573 F.3d 1062, 1080 (10th Cir. 2009). Disgorgement of fraudulently gained profits is "an equitable remedy as to which a trial court is vested with broad discretionary powers." *S.E.C. v. Maxxon, Inc*., 465 F.3d 1174, 1179 (10th Cir. 2006). Disgorgement has also been used as remedy in a misappropriation or unfair-competition cases, where at least one court has properly ordered disgorgement of profits earned from the use of the misappropriated business secrets. *Telex Corp. v. IBM*, 510 F.2d 894, 931 (10th Cir. 1975). In the context of national energy regulation, the Federal Energy Regulatory Commission ("FERC") has been recognized to have the authority to order energy sellers who unjustly or unreasonably exercise market power to

disgorge profits gained by these improper actions. See, *Mont. Consumer Counsel v. FERC,* 659 F.3d 910, 919 (9th Cir. 2011).

Disgorgement is a recognized equitable remedy in New Mexico state law, where the remedy is used to "wrest ill-gotten gains from the hands of a wrong-doer." *Peters Corp. v. N.M. Banquest Investors Corp., 144 N.M. 434, 444 (N.M. 2008),* citing, *S.E.C. v. Huffman,* 996 F.2d 800, 802 (5th Cir. 1993). Importantly, disgorgement is a highly limited remedy, which focuses only on remediation. Disgorgement cannot be used to impose a punitive sanction. *Id.*

As with a request for accounting, a request for disgorgement is by its very nature a derivative, and not a direct, action. See, eg, *Huppe v. WCPS Int'l Inc.*, 670 F.3d 214 (2d Cir. N.Y. 2012); *Roth v. Jennings,* 489 F.3d 499 (2d Cir. N.Y. 2007); *Ohio Drill & Tool Co. v. Johnson,* 498 F.2d 186 (6th Cir. Ohio 1974).

Thus, while the Court has inherent authority to order disgorgement as an equitable remedy in certain cases, Defendant does not believe that the allegations in the current case justify a request for disgorgement. As previously noted, disgorgement is most typically seen in cases where individuals or corporations have improperly gained profits through fraudulent means. In the current suit, Plaintiffs do not make any allegations of fraud. Plaintiffs merely assert, based apparently on little more than their subjective beliefs, that Defendant SEC paid higher than average compensation to trustees and that Defendant SEC retained capital which "should have" been retired and reimbursed to the membership.

While a Court's equitable authority may permit it to order the disgorgement of profits gained through fraud, it is highly unclear that this authority would allow the Court to unilaterally order the reduction of a trustee's benefits and compensation, or to order that an independent corporation "should have" elected to pay out more capital credits (or retained profits in the case

of a for-profit corporation). These issues are generally addressed by the business judgment rule, which expressly requires a court to accept the good faith business decisions of corporate directors and trustees. The Court is, quite simply, not the proper place for the review and reexamination of a corporation's good faith business decisions. Where the shareholders (or members in the case of a cooperative) believe that executive or trustee compensation is excessive, or that additional profits should be paid out, shareholders have the right and the power to use their voting power to remedy these situations.

IV. Matters concerning Derivative Actions.

As noted above, the two substantive requests for relief made in Plaintiffs' First Amended Cross-Claim are both equitable in nature and can only be brought through a derivative action. The derivative nature of Plaintiffs' claims stem from the fact that the rights being asserted are fundamentally rights of the corporation itself, not its members. The New Mexico Rural Electric Cooperative Act, at §62-15-9, NMSA (1978), recognizes the derivative nature of actions made by members against a cooperative by imposing on potential plaintiffs the "notice and investigation" requirement generally required in all derivative suits. The similarity of the requiremetns can be seen by comparing §62-15-9 with the procedures imposed by NMRA 1-23.1 "Derivative Actions by Shareholders", which would Defendant SEC argues applies to the current litigation.

The fact that the current suit is derivative directly resolves many of the concerns raised by the Court in its August 14th letter. In a derivative action, upon notification by the potential plaintiff, a corporation's board of directors has the duty to investigate the allegations being made, and to independently determine whether the litigation should be pursued. Where the board, in its

independent business judgment, determines that litigation is not in the best interest of the corporation, the board generally has the authority to request that the litigation be dismissed. See, eg, *Burks v. Lasker*, 441 U.S. 471 (U.S. 1979). Under these circumstances, when a corporate board petitions a court to dismiss a derivative action, the court is then limited to examining whether or not the board acted independently, in good faith and exercised rational business judgment when concluding that continuing litigation was not in the best interests of the firm. *Id*. at 474-475.

New Mexico's state law regarding the business judgment rule is in accord with the U.S. Supreme Court decision cited above. In New Mexico, "if in the course of management, directors arrive at a decision, within the corporation's powers and their authority, for which there is a reasonable basis, and they act in good faith, as a result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interests of the corporation, ***a court will not interfere with the internal management and substitute its judgment for that of the directors to enjoin or set aside the transaction*** or to surcharge the directors for any resulting loss." *White on Behalf of Banes Co. Derivative Action v. Banes Co*., 116 NM 611, 615, 866 P.2d 339, 343 (1993) (emphasis added).

In the current matter, the proposed Plaintiffs have, at the direction of this Court, brought their concerns to the express notice of Defendant's Board of Trustees, and the larger public, through a special meeting held on July 3, 2012. In cooperation with its accountants, its counsel, various lending authorities, and other business consultants, the Board is currently investigating the matters raised at the July 3rd meeting and reviewing the viability of the requested business activities made by Plaintiffs, including Plaintiffs' request for the early payment of substantial additional capital credits to the membership.

Should the Board, in the exercise of its business judgment, determine that the current litigation and/or the proposed settlement is *not* in the best interests of the Cooperative and its membership, then it is expected that Defendant would move for dismissal of Plaintiffs' proposed suit on these grounds. Should that occur, then the Court's authority will be limited to a review of whether or not the Board determination was made under the proper business judgment standard. Unless the Court finds that the Board acted unreasonably and in bad faith, then the Court is explicitly *lacks* the authority to interfere with the Board's business decision.

In conclusion, the Court has correctly noted that, at least in its current form, the proposed First Amended Cross-Claim raises serious issues of judicial authority to regulate and oversee the actions of private corporations. However, Defendant SEC reasonably believes that several of these requests, such as the proposed Plaintiffs' demands concerning voting districts and elections, are now moot and will not be brought before the Court. The two claims that continue to fundamentally address the Court's authority in this area are the requests for accounting and disgorgement. As equitable remedies which must be brought in a derivative action, these two claims are required to be brought before the Board of Trustees for investigation and action before the filing of any lawsuit. To the extent that the Board acts in its proper business judgment and determines that the proposed litigation is not in the best interests of the corporation, then the Court's authority will be limited to reviewing whether the Board acted independently, reasonably, and in good faith.

Defendant SEC hopes that this memorandum briefing has addressed the concerns raised by the Court in its August 14th letter, and Defendant stands ready to provide additional briefing as requested by the Court.

Sincerely,

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CERTIFICATE OF SERVICE:
I certify that a copy of this Memorandum was served by the Court's electronic filing system to the following counsel of record on this 13th day of October 2012:

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